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Alternative Investment Research

The Search for Fresh Hedge Fund Strategies

Introduction: The Financial Times published an article in its section entitled: "Desperately seeking fresh strategies", (by Robert Clow, FT, Global Investing, 27th June 2002; reprinted FT, Fund Management 1st July 2002). In this note we pick up on some of the points made in that article and explore how the Fund of Hedge Funds (FOHF) industry might address them. For reference the opening paragraphs from that article are as follows:

FT Global Investing: *"It is a struggle to make money in the hedge fund world - a struggle that has lasted for the last year and a half. Hedge funds as a whole racked up a miserly 4 per cent return last year, and half way through this year are on track to do little better.*

Some people are starting to suggest that the answer to the problem is some hedge fund research and development: the funds need to find a new strategy.

Strategy after strategy - from merger arbitrage, convertible arbitrage, long/short equity investing and statistical arbitrage - are all suffering in this lacklustre, sideways-moving market. Aside from distressed bonds and emerging markets, there is very little to get excited about in the hedge fund world."

A historical perspective: We have long argued that the excess returns of the 1990s in HF were the result of a combination of three factors: (1) low transparency (2) low levels of research and (3) relatively low levels of liquidity compared to traditional asset classes. These factors created a premium which bolder players, many who have been in the HF space for decades, were able to capture. In most cases, however, their processes were relatively inefficient. In some instances, the HNWI money that went into HFs during this period was arguable little more than a 'best mates club' investing into talented teams with Soros / Tiger / Tudor et al connections. But this did not matter and their willingness to bear the three 'risk' factors above was rewarded with a long period of superior returns.

Meanwhile more cautious investors, with pension funds at the stickiest end of the spectrum, did not venture in – on the basis they either did not notice the risk/return profile of HFs, or felt it was too unquantifiable to be a realistic investment opportunity. As a result they failed to participate in those early superior returns.

As we know hedge fund outperformance was broadly sustained through to 2001, boosted effectively by the privatization of the major investment banks' prop desks. The industry was given a kicker by the collapse of LTCM. This was at the expense of investors into that fund, including the investment banks exposed to it (and indirectly the US taxpayer who ultimately bore the cost of the Fed's subsequent liquidity injection). Both these events created a significant opportunity set that other HFs were able to monetise.

Excess returns 'arbitraged out'

But, as the FT points out, the game is, if not up, then getting very tough. With the explosion of the FOHF market the first two of those inefficiencies have been largely eroded. Transparency has improved (although older tier 1 funds remains largely opaque) and compelling research has been published espousing the efficacy of a portfolio allocation to Alternative Investment Strategies (AIS). As a result funds have flowed into the space to such an extent that some opportunity sets such as Merger Arb have been effectively 'arbitraged out' - at least in the short term. (When a manager reports that he has 7 Chinese[1] deals in place in the hopes that one will break and that this represents an efficient way to earn a return it is easy to see that the market has taken the spread to little more than a cash return!)

CB Arb remains the next strategy under the spotlight. While managers tell investors that there are no imminent problems on the horizon there remain a number of key issues concerning the size of HF participation in the market. When a strategy becomes the market, its risk rises disproportionately. Whatever the managers say, there is ultimately a finite opportunity set in any strategy and there will come a point when excess returns are either arbitraged out or some unforeseen event causes a more dramatic problem. Currently there appears to be still some steam left in the strategy but how much remains to be seen.[2]

FOHF liquidity has improved

On the third factor above, liquidity still remains limited and hence should be rewarded with some premium. That is not to say it has not improved, as FOHFs have done much to improve the situation, allowing easier access for smaller investors and with more frequent dealing. Minimums investments into FOHF are frequently as low as $10k compared to anything up to $10m for underlying funds; and most FOHFs have monthly dealing versus quarterly or annually for some of underlying managers.

Market inefficiencies harder to capture

So what does all this mean for the industry? In the first place much of the inefficiency that made the HF space so attractive 10 years ago has been absorbed. That is not to say that talented managers cannot find opportunities that less skilled market participants have either overlooked or even created. But gaining access to such managers has become increasingly hard, given capacity limitations facing the industry as a whole. As one long-standing multi-strategy manager admitted at a recent prime broker conference: "It has become increasingly hard to make money in the current environment. To do it you need more people - and more talented people - and this costs money."

Higher fees:

Which brings us onto the question of fees. As returns have become harder to generate, managers are forced to hire extra staff and/or beef up their systems capability. All of which eats into the bottom line. Managers not surprisingly have attempted to pass on higher costs to their investors in the form of higher fees. Where once 1% and 20% was the standard for hedge funds, the current norm is tending towards 2% and 20%. This has two effects. The first is that higher fees eat into what are already lean sources of return, so that investors are charged more for less return. The second, follow-on point, is that at some point investors

[1] Traditionally Merger Arbitrageurs are long the spread between a target company and its acquirer in a takeover situation, profiting as the two positions converge when the deal closes. A Chinese – or backward – position inn a deal situation occurs when the manager is short the spread on the expectation that the deal will break.

[2] For a more detailed discussion of the prospects for Convertible Bond Arbitrage as a strategy see the AIMA Newsletter, *Convertible Bond Arbitrage – Relative Value Trading,* February 2002.

will balk. While this is unlikely to happen in an industry which offers returns ahead of other asset classes, investors will at some point in the future remember that the justification for performance fees was that HF managers represented that their superior skills would allow them to generate superior returns. In order to convince investors of this, the tacit agreement was that the manager would take a lower management fee while extracting a greater overall fee by means of the performance fee. This aligned investor and manager interests and also created a barrier to entry as less skilled managers, unable to generate high absolute returns, would suffer a drop in revenues.

What has since happened is that investors now pay not only the same level of performance fees but also a higher management fee. This is a win-win situation for managers and arguably no longer aligns manager-investor interests. It has also made the hedge fund space attractive to unskilled managers. A cynical investor might therefore take the view that, like investors in US Tech and Telecoms stocks in the late 1990s, and Emerging Markets investors in 1997/98 – that they are playing a game rigged in favour of insiders.

Low interest rate environment further compresses returns

Added to this is the issue of the current low interest rate environment, which has compressed Relative Value and Spread-Trading strategies. Arguably investor expectations should be lower as a result, although this does not appear to have happened. In some part it is the fault of HFs themselves which continue to project mid-to-high double-digit returns in their marketing material. The FT itself referred to a “miserly 4 per cent return” from HFs last year [2001] – yet this is still twice the US cash rate and significantly better than an investment into most other asset classes. To clarify this point, a return of twice the risk free rate in 2000/01 would have yielded 12% - quite acceptable in absolute terms. Yet in 2002 should offer just 3.5% given the prevailing Fed Funds rate at mid-year – which now qualifies as “miserly”.

To some extent we have painted a bleak picture of the prospects for the hedge fund industry. But we feel that it is important to analyse it clearly and not present it in panglossian fashion. For some time there has been a temptation on the part of FOHF participants to espouse to investors that they should invest in hedge funds and forget the traditional markets. In contrast to this there is a desire by the press to declare that the hedge fund emperor has got no clothes. Our view is between these two extremes. Hedge funds represent an opportunity set but that investors should always spread their risks. True hedge funds trade some form of market inefficiency; for that to exist requires functioning underlying traditional markets (in the same way that index funds require an active market to function).

Herd mentality:

Short-term inefficiencies will continue to persist in the market place, so long as there are non-economic or non-rational buyers and sellers. Recent market turmoil – from the Internet bubble to the dumping of junk bonds by pension funds – demonstrates this. Capturing those inefficiencies has simply become more difficult – at both an individual fund and a FOHF level.

At the individual fund level the problem is likely to persist given the weight of money that has flown into the major style headings. Hence, for example, while some Merger Arb managers will do well, others will under-perform. The same applies to the other major style headings. But here we believe there is an interesting anomaly – that of agency friction within the FOHF world.

We believe that certain FOHF managers, particularly those with an institutional nature will tend to favour the principal style headings at the expense of niche and exotic strategies. There is an element of herd mentality in this. The situation is compounded since the same players typically have larger asset bases. Their need for a minimum level of assets in an underlying fund can prevent them from investing into small niche-focused strategies. In the same way that a pension consultant is unlikely to face recrimination for investing into a large blue-chip company, a HF allocator is less likely to be admonished for recommending a manager in one of the key style headings.

The FOHF industry is therefore clustered into the more identifiable strategies, opening the way up for nimbler FOHF players, and those with the willingness to venture into more esoteric strategies to outperform.

Strategy cyclicality

The FT lights upon the outperformance of Distressed Debt and Emerging Markets. We believe that this is symptomatic of the same agency friction. FOHFs that performed well by avoiding areas that were historically associated with poor or risky returns (Distressed Debt was lacklustre for most of the last decade, while Emerging Markets effectively blew up in 1997/98) have been slow to research or return to these areas. Only recently have they begun to redress this. This will likely lead in due course to an erosion of performance and an over-allocation of capital, although outperformance should persist until that occurs.

New manager phenomenon

Established FOHFs also have a reluctance to allocate to new managers i.e. those with a track record shorter than two years, despite compelling research[3] that suggests younger funds outperform their older peers. Intuitively this makes sense given that newer managers are likely to: (1) have smaller asset bases and therefore greater nimbleness and flexibility in implementing trades; (2) have fresh ideas brought from previous investment houses where they may have been unable to implement them; and (3) a greater drive to succeed given the need to establish reputational and compensational success. Inevitably investing with newer managers carries risks but we believe that thorough due diligence should allow FOHFs to mitigate that risk and earn a commensurate premium.

Conclusion:

A combination of asset flows, rising fees and a low risk free rate have compressed returns in core strategies. FOHFs with access to premier hedge funds (generally closed to new entrants) can expect to benefit from their superior skill in extracting returns from increasingly efficient markets. FOHFs with access to these managers will likely continue to use these as a core for their portfolios. New entrants may be forced to allocate to style headings, with limited choice other than to select less capable managers in order to be able to fill gaps in their allocation models. This may be at the expense of an allocation to less established but potentially higher-returning skill-based strategies. FOHFs with the willingness to look beyond the major style headings into more esoteric and under-researched strategies should expect to pick up a return premium commensurate with the risk and effort required researching those strategies. Boutique FOHFs with compact asset bases and the flexibility to move them more freely should enjoy an advantage over institutional FOHFs constrained by agency issues. This will include allocating to new single-strategy managers with short track records and smaller asset bases.

Market inefficiencies will persist but both single-strategy HFs and FOHFs will need to be increasingly imaginative if they are to capture these returns while

[3] Morgan Stanley Dean Witter, *Why Hedge Funds Make Sense,* November 2000

maintaining risk at required levels.

Overall, while we agree that a number of the established strategy headings will suffer from ”lacklustre, sideways-moving” returns for some time, we disagree that “there is very little to get excited about in the hedge fund world”. In contrast it is our view that there remains much to get excited about, particularly given the turmoil in both equity and credit markets. Imaginative, flexible and creative FOHFs willing to research and invest into a broader range of AIS should continue to deliver on their objective of achieving consistent, absolute non-correlated returns, with low associated volatility, regardless of market cycle.